City of Detroit

OFFICE OF THE AUDITOR GENERAL

Audit of the Detroit Neighborhood Development Corporation February 2006

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MEMORANDUM

DATE: April 11, 2006

TO: Honorable City Council

FROM: Loren E. Monroe Loren E Monroe
Auditor General

RE: Audit of the Detroit Neighborhood Development Corporation

C: Mayor Kwame M. Kilpatrick
Reuben Munday, Lewis and Munday, PC
Douglass Diggs, Planning and Development Department

Attached for your review is our report on the audit of the Detroit Neighborhood Development Corporation.

This report contains our audit purpose, scope, objectives, and methodology; background; audit findings and recommendations; and the agency's response.

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Audit of the Detroit Neighborhood Development Corporation

February 2006

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AUDIT PURPOSE, SCOPE, OBJECTIVES, AND METHODOLOGY

Audit Purpose

The Office of the Auditor General (OAG) initiated the audit of the Detroit Neighborhood Development Corporation (DNDC) after conducting a preliminary analysis of information related to issues brought to the attention of the OAG by media reports. Media reports indicated that Henry Hagood, then the Planning and Development Department (PDD) Director, sold City-owned properties to longtime friends Dalton Brown, Marcellus Oree and Vershawn Oree on at least three occasions. Our analysis of property sales involving Mr. Brown and the Orees revealed that a large number of these properties were sold through the DNDC.

Audit Scope

The scope of the audit included the period January 2001 through September 2005.

Our audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States, except that the OAG has not received an external peer review within the past three years.

Audit Objectives

The OAG conducted an audit of the DNDC to:

- Document the use of $10.7 million in funding provided by the PDD to the DNDC.
- Document the estimated $4.6 million in rental and sales income generated by the DNDC.
- Determine the policies, procedures, and plans that the DNDC developed to rehabilitate and dispose of the properties.
- Determine the inventory and planned disposition of the remaining properties.

Audit Methodology

To accomplish the audit objectives, our audit included:

- Interviews of PDD personnel and DNDC officials involved in the sale of DNDC property;
- Examination of property sales files to verify documentation of the pricing and sales process;
- Review of DNDC board minutes and financial records;
- Examination of State of Michigan Department of Labor and Economic Growth records;
- Examination of Wayne County Register of Deeds' records; and
- Other audit procedures we considered necessary to achieve our audit objectives.

BACKGROUND

The City established and contracted with the Detroit Neighborhood Development Corporation (DNDC), a non-profit organization, in 2001, to acquire the interest of a former creditor, clear titles, rehabilitate, manage, and sell properties formerly owned by two failed real estate and financing companies. When the DNDC purchased the portfolio, no title work had been ordered. The properties had been mortgaged and re-mortgaged many times, which resulted in title defects.

The City issued general obligation bonds, in 2001, to fund DNDC expenses related to the purchase, rehabilitation and sale of the properties. To ensure appropriate oversight, City employees and appointees, initially the Planning and Development Department (PDD) employees and appointees, have served as DNDC officers since it was established. The mission of the PDD is to strengthen and revitalize the City of Detroit's neighborhoods and communities and to stabilize and transform the physical, social and economic environment. The PDD procures, sells, manages and maintains City-owned real estate to develop and stabilize neighborhoods and promote business growth.

The original DNDC board members, including members responsible for the establishment of the Barton Rental Management System, a wholly owned for-profit subsidiary, resigned in January 2002. New board members began functioning in February 2002. Under the initial board, the City paid the DNDC $8,989,838 in bond proceeds. In 2002 the City paid the DNDC an additional $1,185,066.48 in bond proceeds. In July 2002, the DNDC board returned $676,370.25 of unspent bond proceeds to the City. However, in 2003 the City paid the DNDC another $495,938.95 in bond proceeds.

On August 25 2005, Fox 2 News reported that Henry Hagood, then PDD Development Director, sold City-owned properties, at reduced prices, to longtime friends Dalton Brown, Marcellus Oree and Vershawn Oree on at least three occasions. Based on our preliminary analysis and news reports, the Office of the Auditor General (OAG) initiated an investigation of the sales of City-owned property at the PDD.

The OAG reviewed property sales involving Mr. Brown and the Orees for the period September 20, 2002 through January 7, 2005. Our review focused on property sales recorded at the Wayne County Register of Deeds. We also reviewed corporate records filed with the State of Michigan Department of Labor and Economic Growth. Based on our analysis of these sales, we initiated our investigation of properties sold through the DNDC.

During our analysis, we identified a large number of property sales to the aforementioned individuals and/or the companies they represented. We determined that the initial seller of these properties was the DNDC rather than the PDD. We identified a pattern of immediate resale of these properties for what appeared to be a sizable profit. Some of the property sales prices were shielded from public record by tax valuation affidavits. The pattern of resale at higher prices raised questions as to whether the DNDC sold the properties for amounts less than market value and whether the DNDC made any effort to sell the properties to obtain the fairest and greatest benefit for the City. We identified the following as the major property purchasers of the DNDC property sales:

- Chayne Holding Group (Dalton Brown)

- Rayford Development and RAS Development Group (Rayford Jackson)
- New Detroit Real Estate (Mark Shows)
- Walter Turner

Dalton Brown/Chayne Holding Group and Rayford Jackson/Rayford Development and RAS Development Group subsequently sold properties purchased from the DNDC to:

- MV Holdings whose principals include Marcellus and Vershawn Oree; and
- Lantech Custom Homes whose principals include Durand Jackson and Mary Coates.

On September 15, 2005, we made our first request for the DNDC records from the PDD. As of November 16, 2005, the DNDC had not provided the OAG access to its records. On November 16, 2005, we issued a memorandum to the Honorable City Council with the results of our analysis to the extent the data allowed. As a result of the recommendations made in the memorandum, the City Council and the Office of the Auditor General, issued joint subpoenas, ordering the production of named documents and the appearance for testimony on January 19, 2006. That appearance date was later adjourned to allow our office adequate time to audit the documents produced by the DNDC and to develop this report.

On December 2, 2005, the DNDC produced some of the documents originally requested on September 16, 2005. On December 28, 2005, the DNDC produced some of the documents ordered in the subpoena. We were informed that the DNDC had discontinued its operations in June 2005 and there were no employees on the DNDC's payroll. We were unable to access or obtain information from former DNDC employees. However, two PDD employees, one of whom served as a DNDC board member, were very cooperative in providing DNDC background information and available documentation. After the DNDC board was reconstituted in 2005, the new board president, a former PDD employee, was also helpful in facilitating the delivery of information in response to the joint subpoena.

FINDINGS AND RECOMMENDATIONS

1. Poor City Oversight of the DNDC

The City did not exercise adequate oversight of the DNDC operations and its use of $10.7 million in general obligation bond proceeds. The following issues raised questions regarding the governance provided by the DNDC board:

- The DNDC's mission was to acquire, rehabilitate, and sell approximately 1,176 properties. During its operations, the DNDC only rehabilitated eight properties at a cost of $295,000.
- The DNDC could not provide any formal policies, procedures, and plans to rehabilitate and dispose of the properties.
- After the DNDC expended $12 million, 426 properties (37% of the initial inventory) remain unsold.
- Although the contract between the City and the DNDC required monthly reports, the DNDC could not provide copies of the reports. We were informed that the DNDC did not submit monthly reports to the City or the Board members.
- As described in finding 2, the DNDC board did not ensure that the DNDC expended funds in accordance with general obligation bond legal requirements.
- Despite expending $104,034 on audit expenses, and operating for over four years, the DNDC obtained only one audit of its financial statements. That audit was for the period ending March 31, 2002.
- The DNDC did not file any annual tax returns.
- The DNDC could not produce its general ledger records as reported in finding 2.

Effective governance requires strong leadership that knows and adheres to the organization's mission, leadership that evaluates the organization's challenges and opportunities and adapts strategies to meet them. Boards members are responsible for taking the appropriate action to fulfill its fiduciary responsibilities. As fiduciaries for the organization's assets and mission, board members are positioned to demand accountability—of the organization itself, of the organization's contractors and of themselves. Boards operate in their fiduciary role when they ask questions to ensure appropriate expenditure of funds. Boards operate in their strategic role when they help the organization define, assess, and redefine plans.

Recommendation

We recommend that the City clearly define the duties and responsibilities of appointed Board members to ensure the appropriate level of oversight is achieved and to help ensure that each organization's mission is accomplished and the City's resources are safeguarded and used efficiently and effectively.

2. General Obligation Bond Proceeds Used to Fund Administrative Expenses

The DNDC used general obligation bond proceeds to fund $2.6 million in expenses that did not qualify as capital project expenses. As a result, the DNDC used proceeds of general obligation bonds contrary to the intent of the voters' approval.

The PDD contracted with the DNDC to acquire, rehabilitate and bring up to code, clear titles, manage rental and vacant properties, and sell approximately 1,176 properties formerly owned by Rogers Investment Management Co. (RIMCO) and MCA Financial Corp. (MCA). The PDD paid the DNDC a total of $10.7 million on the contract using general obligation bond proceeds.

Calendar Year	Bond Proceeds Paid to the DNDC	Bond Proceeds Returned to the City by the DNDC	Net Bond Proceeds Paid to the DNDC
2001	$8,989,838.36		$8,989,838.36
2002	1,185,066.48	($676,370.25)	508,696.23
2003	495,938.95		495,938.95
Total	**$10,670,843.79**	**($676,370.25)**	**$9,994,473.54**

City financial records document that $5.6 million was paid to the DNDC to acquire 1,176 RIMCO/MCA properties. The remaining $5.1 million was paid to the DNDC for advances, rehabilitation and operating expenses. In July 2002, the DNDC board members wrote two checks to the City of Detroit totaling $676,370.25 to return unspent bond proceeds.

The DNDC Income and Expense schedules documented that the DNDC expended $12,039,589 between January 2001 and May 2005. Of the $12 million reported as expended, the DNDC expended $2.6 million on operating expenses that are more appropriately classified as administrative expenses. The general obligation bond resolution and prospectus indicates that the purpose of the general obligation bond issuance was to fund capital projects, specifically the acquisition, rehabilitation and title work necessary for the subsequent sale of properties. Therefore, administrative expenses are outside of the definition of capital project expenditures and the funding of these types of expenses is an improper use of the bond proceeds. Improper use of bond proceeds may require a change in the tax status of bonds from a non-taxable to a taxable status.

The DNDC board members and City employees were aware that bond proceeds were used to fund the DNDC operating expenses and questions were raised as to the propriety of funding the expenses. Although DNDC board members returned unspent bond funds in 2002, we found no evidence that the DNDC board members ever advised the DNDC to discontinue using bond proceeds to fund operating expenses and more specifically administrative expenses. Given the current financial position of the DNDC, the City will not be able to recover those funds.

Recommendation
We recommend that the City ensure that bond proceeds are utilized in accordance with legal requirements by informing the recipients of bond proceeds of the allowable and unallowable uses. We also recommend that City appointed board members exercise the oversight necessary to ensure that City funds are expended in accordance with any legal or grant requirements.

3. Inadequate Reporting of Rental and Sales Income

The financial records provided by the DNDC do not capture the total amount of rental and sales income received by the DNDC. The lack of audited financial information and the DNDC's use of multiple rental management companies, impeded our ability to determine the total amount of rental and sales income collected by the DNDC.

To facilitate our analysis of the DNDC financial transactions, the subpoena ordered the production of DNDC's: accounting records for the period of January 1, 2001 to September 30, 2005, including but not limited to general ledger records and DNDC's Profit and Loss Statements and Balance Sheets; and any and all DNDC audit reports and tax returns. The DNDC did not provide its general ledger records as ordered in the subpoena. Instead, the DNDC provided us with unaudited Income and Expense schedules for calendar years 2001, 2002, 2003, 2004, and the period January through May 2005. The DNDC indicated that it had obtained only one audit since its inception and provided its audit report for the 15-month period ended March 31, 2002. Also, the DNDC indicated that it had not filed a tax return since its inception.

While the audited financial statements included the financial transactions of the Barton Rental Management System, a wholly-owned for-profit subsidiary of the DNDC, the unaudited Income and Expense schedules did not. The DNDC could only locate the 2004 Barton Rental Management System Income Statement. Based on these factors, we believe the DNDC Income and Expense schedules are inaccurate and incomplete because the amounts related to rental income differed substantially from the rental income reported in the audited financial statements for the same time period.

The DNDC Income and Expense schedules indicate the total rental and sales income to be $1.4 million, which is substantially less than the $2.0 million reported in the audited financial statements for the 15-month period ending March 31, 2002. Moreover, in a monitoring review performed by the PDD in December 2001, the PDD indicated that the DNDC received rental receipts of $664,751 from January 2001 through June 2001, but failed to report receipt of the income to the PDD.

The DNDC was to utilize the general obligation bond proceeds for the acquisition, rehabilitation and sale of the properties. Rental and sales income were to be used to fund the DNDC's operating expenses. However, in the early years of the DNDC, the rental and sales income stream was insufficient to support the operating expenses of the DNDC. As described in finding 2, *General Obligation Bond Proceeds Used to Fund Administrative Expenses*, the DNDC used bond proceeds to cover these costs.

The DNDC used a number of companies to manage its rental properties, while the DNDC managed the properties to be sold. Initially, the Neighborhood Management Corporation (NMC), which consisted of former RIMCO employees, managed the rental properties. The DNDC indicated that the rental income received from January 2001 through June 2001 was rental income for the NMC. However in 2001, the DNDC paid NMC $1,044,244 for its services.

In July 2001, the DNDC established Barton Rental Management System, a wholly owned for-profit subsidiary of DNDC, to manage its rental properties and collect rents. The DNDC Board minutes, provided to us, did not document the rationale for establishing a wholly-owned for-profit subsidiary to perform the functions that DNDC was established to perform.

Although the DNDC operated from 2001 through 2005, it filed no annual income tax returns and completed only one audit. The DNDC had a legal and fiduciary responsibility to complete and file its annual tax returns. Good business practices warrant the engagement of an annual audit. Establishment of a for-profit subsidiary increased the DNDC's responsibility to prepare and annually file its income tax returns.

Recommendation
We recommend that the DNDC board ensure that the DNDC complies with any legal requirements until the remaining properties are sold and DNDC discontinues operations.

4. DNDC Policies, Procedures, and Plans to Rehabilitate and Dispose of the Properties

The DNDC did not provide us with a documented policy or plan regarding the rehabilitation and disposal of the properties. The DNDC board that assumed its position in 2002, determined that given the cost of operating the DNDC and paying its outstanding debts, it decided to cease using bond funds and to dispose of the DNDC's interests in the MCA/RIMCO properties as quickly as possible. Only 8 of 1,176 properties were rehabilitated at a cost of approximately $295,000.

To liquidate the properties, the DNDC indicated that it issued two requests for proposals (one requesting proposals to rehabilitate DNDC properties and the other requesting bids for the bulk purchase of properties) to attract the best price available for the DNDC's property interests, leaving it to the purchaser to pay all outstanding taxes, liens, water bills, title insurance expenses and other costs of any and all kinds. DNDC properties were sold to purchasers "as-is/where-is," with no representation or warranty by the DNDC as to the marketability of the interest being purchased. It is the DNDC's position that its expeditious sale of the properties assured the DNDC and the City that parties other than the City would pay outstanding taxes on the properties and that the properties would be put back on the tax rolls.

The DNDC records indicate that it sold 750 properties. We were informed that a DNDC consultant is negotiating a bulk sale of the 426 properties that remain in the DNDC portfolio.

ATTACHMENT A

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** RESIDENT IN SEATTLE
*** RESIDENT IN NEW YORK

Otis M. Smith
(1922-1994)

Herbert O. Reid, Sr.
(1915-1991)

April 11, 2006

Loren Monroe, CPA
Auditor General
Office of the Auditor General
2 Woodward Avenue, Room 208
Detroit, Michigan 48226

<u>VIA ELECTRONIC MAIL AND FIRST CLASS U.S.MAIL</u>

Re: Detroit Neighborhood Development Corporation

Dear Mr. Monroe:

Please find enclosed the response of the Detroit Neighborhood Development Corporation ("DNDC") Board of Directors to the audit of the DNDC by the Office of the Auditor General. Submission of this response was authorized by the DNDC Board, which is comprised of Walter C. Watkins, Kathleen Royal and Matthew Grady.

Please call me with any questions.

Very truly yours,

LEWIS & MUNDAY
A Professional Corporation

Reuben A. Munday

RAM/kww

cc: Sharon Gipson (via electronic mail)

Enclosure

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ADMITTED IN: 1 MICHIGAN; 2 DISTRICT OF COLUMBIA; 3 NEW YORK; 4 MARYLAND; 5 MASSACHUSETTS; 6 ILLINOIS; 7 WASHINGTON; 8 CALIFORNIA.

April 11, 2006

Loren E. Monroe, Auditor General
Office of the Auditor General
2 Woodward Avenue
Coleman A. Young Municipal Center, Room 208
Detroit, Michigan 48226

Dear Mr. Monroe:

The following represents the Detroit Neighborhood Development Corporation's (the "DNDC") response to the findings and related recommendations in the March, 2006 Audit of the DNDC, as prepared by the Office of the Auditor General.

Background

We would like to make a few general observations here before commenting on specific statements in the report.

First, the DNDC and Barton Rental Management ("Barton") were created by DNDC Board members appointed by the Archer administration, all of whom resigned effective January 1, 2002. This point is important because the DNDC Board members who resigned are the persons in the best position to explain the original goals of the DNDC and Barton and to offer their view on whether those objectives were met during their tenure.

Second, it is our understanding, based upon a review of the history of the organization, that the City of Detroit did not originally intend to purchase properties impacted by the RIMCO bankruptcy. We have it upon information and belief that properties were only purchased by the DNDC after creditors with liens on RIMCO properties complained about the management of the properties and threatened to sue the City. A judgment was made prior to the appointment of the current DNDC Board to purchase unspecified interests in RIMCO properties.

Third, what the DNDC purchased was not title in fee simple absolute, but was simply the unspecified interests of the referenced RIMCO creditors, if any, and the purchase of such "interests" was made without representation or warranty by the RIMCO creditors. This is important, we believe, when considering whether the DNDC received "fair value" for its subsequent sales.

Fourth, in the third full paragraph of the background section, in the last sentence, the report notes that "the City paid the DNDC another $495,938.95 in bond proceeds." Those funds, to our knowledge, were used to pay for capital improvements to the portfolio consisting of necessary repairs and for property taxes. Both of those expenditure types were proper uses of bond proceeds.

Finally, in the sixth full paragraph of the background section, the report notes that "some of the property sales prices were shielded from public record by tax valuation affidavits." Tax valuation affidavits are commonly used in Michigan, are public records like deeds and are therefore subject to public disclosure.

Finding No. 1. Poor City Oversight of the DNDC

DNDC's Response:

Again, we would like to make some observations here before commenting on specific provisions in the report.

First, all City funds expended on DNDC property interests were made by the DNDC Board that resigned as of January 1, 2002 and not by the Board that is responding to this report. It is important to keep clear the timeline of the expenditure of City funds on behalf of the DNDC to make sure that the current Board is only responding to issues that have been raised with respect to decisions that were made by this Board.

Specifically, in the fifth bullet point under this heading, the report notes that "the DNDC board did not ensure that the DNDC expended funds in accordance with general obligation bond legal requirements." We would like to point out that the Board which was appointed in early 2002, did instruct that no further bond funds should be expended on operating expenses. In fact, the new Board, as noted in this report, returned all bond funds to the City that were not used for appropriate expenditures.

With respect to the recommendation, the DNDC Board has no objection to the recommendation.

Finding No. 2. General Obligation Bond Proceeds Used to Fund Administrative Expenses

DNDC's Response:

Again, we would like to make some observations here before commenting on specific provisions in the report.

As early as April of 2002, shortly after its appointment, the Board responding to the report determined that no additional bond funds should be expended on operating expenses. The Board further determined that the expenditure of such bond funds on capital expenditures without the availability of adequate operating funds would be a waste of City money and that the only way to avoid the deterioration of the DNDC property interests would be to expeditiously sell the DNDC's interest in the properties.

Specifically, in the fourth paragraph under this heading, the report states that the Auditor General found no evidence that the DNDC board members ever advised the DNDC to discontinue using bond proceeds to fund operating expenses. Although there might not be a record of such decision having been taken in Board meeting minutes, it should be clear from the DNDC Board members' return of unspent bond funds in 2002 that the Board had indeed made such a decision and given such direction. Otherwise, bond funds would continue to have been inappropriately expended.

With respect to the recommendation, all bond funds were returned to the City as instructed by the DNDC Board.

Finding No. 3: Inadequate Reporting of Rental and Sales Income

DNDC's Response:

The Board will make every attempt in the coming weeks to file all delinquent tax returns, to the extent that information adequate to do so is available.

We have no comments on Finding No. 4.